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230802Z Dec 05

UNCLAS SECTION 01 OF 04 MANILA 005951

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E.O. 12958: N/A
TAGS: EFIN ECON PGOV EINV RP
SUBJECT: Banking System More Stable But Still Vulnerable

Ref: a) Manila 5519 b) Manila 4639

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Summary

¶1. (SBU) The Philippine Government is working to overcome the reputation of the banking sector as weak and inefficient with insufficient oversight. Although it remains fragmented, the central bank has successfully encouraged consolidation and has introduced many reforms to strengthen banks and compel them to clean up their non-performing loans (ref a) while introducing more rigid accounting standards and improving its own management capability. The Central Bank is updating and expanding banking regulations in line with international best practices, strengthening banking sector oversight and governance, and pushing for revisions to its charter that will expand legal protection and authority. End Summary.

Banking System Overview

¶2. (U) Currently, there are 40 commercial banks in the Philippines along with 83 thrift banks and 750 rural and cooperative banks. The commercial banks control 91% of total banking sector assets, amounting to 3.9 trillion pesos ($72 billion). This is approximately 80% of Philippine GDP in 2004, one of the lowest percentages in the region. Bear Sterns noted in comparison that these assets were $11 billion less than the total assets of Singapore's second-ranked bank, United Overseas Bank, at end-2004. Only Indonesia and India have smaller proportion of bank assets per GDP, though the Philippine ratio compares favorably with many emerging market banking systems outside of Asia.

¶3. (U) Fourteen of the 40 commercial banks are branches of foreign banks that collectively own 14% of the total assets in the banking system. The four biggest foreign banks -- Citibank N.A., Standard Chartered, Hong Kong Shanghai Bank Corporation (HSBC), and Bank of America -- hold 65% of foreign bank assets. The GRP passed legislation in 1994 (the Foreign Bank Liberalization Act) opening up the banking sector to 10 more foreign-branch banks, or to own up to 60 percent of a new or existing local subsidiary. All ten slots have been filled. The Philippines is, therefore, currently closed to banking institutions seeking to operate as foreign branch banks in the country. Foreign branch banks that were allowed entry under the 1994 legislation are limited to putting up six branch offices each. The four foreign banks that had been operating in the Philippines prior to 1948 were each allowed to open a maximum of six additional branch offices. Current regulations mandate that majority Filipino-owned domestic banks should at all times control 70 percent or more of total banking system assets. Rural banking remains closed to foreigners.

Reigning in Excess Cash

¶4. (U) As one of its monetary policy measures, the Central Bank (Bangko Sentral ng Pilipinas, or BSP) adjusts the banking sector's required reserve ratio of deposits to loans to control the supply of pesos. It increased the reserve ratio by 2 percentage points in July 2005 to 21% because of the high volume of pesos in the market. Each bank must now hold 10% of its pesos in "regular" reserves with the BSP at zero or minimal interest rates. Banks must hold another 11% in

"liquidity" reserves, which can be invested in market-yield government securities. In addition, the BSP has raised overnight policy rates by 0.75 percentage points thus far in 2005.

¶5. (U) Even with the increase in reserves requirements and policy rates, domestic liquidity has risen 14% for the year through October. BSP Governor Tetangco attributed the sustained expansion in the money supply to the large amount of hard currency remitted from overseas workers (ref b) and portfolio investments in the resurgent stock market. The BSP reported November 30 that the speculative financing flows of $2.1 billion so far in 2005 are already four times greater than all of last year. The bulk of this hot money went into the stock market, which closed near the 2100 level on December 1. Bankers noted that the BSP has resisted taking some of the pesos out of circulation by either raising the reserve requirement or selling securities on the open market because the BSP is already flush with cash. As one indication, the BSP's foreign assets have increased year-on-year by 9.7% while its foreign liabilities declined by 50%.

Neither a Borrower Nor a Lender Be

¶6. (SBU) One feature of the banking system since the Asian financial crisis is its reluctance to make new loans. Bankers commented to Econoff that the corporate sector has few major expansion plans that require outside funding and so are not interested in loans. "There is little corporate appetite to expand because of political uncertainties, weak infrastructure, and regulatory uncertainty," said one banker. Because of the huge amount of cash chasing few customers, it is a borrower's market. The competition creates a low spread between consumer deposit and loan interest rates, compelling banks to chase after their elite customers to maximize lending and reduce risk. Even so, the Philippines has the lowest ratio of consumer loans to deposits among all the countries in Southeast Asia - only 53% and falling. Loans account for less than 40% of total assets and this ratio is also on the decline. Deposits are growing more rapidly than loans, to the detriment of economic recovery and job creation, though it helps the government to issue new bonds for financing the budget deficit.

¶7. (SBU) BSP Deputy Governor Espenilla admitted that Philippine industry growth is primarily in the service sector, not in manufacturing where the country needs it. Instead of corporate lending, it is consumer lending that is growing rapidly, fueled by the massive growth in overseas remittances. There has been double-digit growth in credit card issuance and use, he said, as well as auto loans. The BSP is developing credit information system legislation that will force credit providers to submit customer accounts and transaction history into a central data bureau that will help ensure individuals do not take on excessive amounts of lending.

¶8. (SBU) As a result of the low loan rate, the Philippine banking system's role as an investor in fixed income securities is almost as important as its role as provider of loans. Thus, around one-quarter of RP bank assets consist of securities - largely bonds - issued primarily by the GRP, though RP banks and corporations have begun to issue their own smaller dollar-denominated bonds as well. Citibank Vice-President for Debt and Capital Markets Cheli Tabuena said the private banking sector issues only 5% of the bonds in the Philippines by value, but this number is growing quickly.

Consolidation, Not Expansion

¶9. (SBU) Another structural aspect of the Philippine banking system is its fragmentation, with 40 banks in a roughly $100 billion economy, compounding a severe concentration of assets in a small number of banks. Twenty-four of the banks accounted for less than 1% of banking system assets. The top five individual banks (Metrobank, Bank of the Philippine Islands, EPCI, Landbank, and Citibank) account for 48% of the assets and the top ten banks account for 71%. According to Bear Sterns, this ownership concentration is growing after recent consolidations of banks within the Sy family (Equitable and PCI which will likely merge with Banco de Oro) and by Lucio Tan, who owns Allied Bank and bought out the government shares in Philippine National Bank.

¶10. (SBU) The BSP is encouraging the banking industry to merge or stand on its own feet. Espenilla said he hoped the number of banks would eventually dwindle to

less than a dozen. The General Banking Law of 2000 created a seven-year window during which foreign banks may own up to 100 percent of one locally incorporated commercial or thrift bank. However, these investments can be made only in existing and not new banks; since 1999, the BSP has imposed a complete moratorium on new bank licenses, except for those engaged in micro-finance. Already several banks have merged (down from 42 commercial banks in 2004 to 40 at present) and others are in various stages of takeover by larger banks. Citibank, for example, is taking over the 53 branch offices of Insular Bank and JP Morgan may be taking over a small bank chain soon as well. The BSP announced in November a partial liberalization of its branch moratorium for domestic banks outside of seven core cities, including Manila, where branching will remain frozen. The BSP also announced relaxation of rules to give bank automatic extension of special licenses for certain banking activities unless revoked for cause.

Other Banking Sector Reforms

¶11. (SBU) Espenilla told econoff that the GRP has drafted a law creating independent retirement accounts with tax incentives. It has also promoted revisions to the investment competency act to develop mutual fund standards, and a fixed income exchange to encourage more transparent trading and clearing systems for fixed income recipients. The GRP has finalized its rules for third party custodianship, which will require a separate bank to sell securities from an account-holder's regular bank. This boosts consumer protection, prudential standards, and capital market development, he said.

¶12. (SBU) Otherwise, the BSP is updating and expanding banking regulations in line with international best practices, using the standards and codes of the Basel II conference. Espenilla said he hopes to strengthen risk-based management and impose risk-based capital, improve corporate governance, and strengthen the appraisal process through USAID to evaluate the banking system assets. (Note: The BSP is advocating for the passage of a credit bureau bill, now pending before the Senate and Congress, that will mandate all banks and other major credit providers to submit customer credit accounts and transaction history into a central credit bureau that will guide credit providers in screening prospective borrowers. USAID assisted the BSP in developing the bill and studying credit bureau operations. End Note.) He said the BSP needs an amendment to its charter, especially parts related to legal protection and authority. For example, there have been many suits against individuals in the BSP, including a number against the former Deputy Governor, because the laws are unclear or weak regarding the ability to close down or restrict lending from banks in jeopardy. Recently, Espenilla commented, the BSP has been winning its cases since the Monetary Board granted them more leeway to hire better lawyers.

Comment

¶13. (SBU) Based on the positive developments listed above, the banking sector's reputation and impact on the investment climate deserve reconsideration. The BSP has had a series of strong leaders with acumen and foresight. Their efforts have resulted in a banking sector that is more stable, efficient, and transparent than at any time in the past and could, provided reforms continue, eventually rise to rival the effectiveness of financial systems in the region.

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